



Global Real Estate Investing Offers Multiple Blueprints for Custom Exposures

Despite recent price turbulence in many developed world real estate markets, global real estate as an asset class continues to offer long-term institutional investors several important benefits: portfolio diversification through low correlations to other asset classes, solid cash flows and a measure of inflation protection through index-linked rents. Investing in real estate across the world enhances this diversification by allowing investors to choose among the strengths and weaknesses of local property markets as they evolve.

There are many ways to design exposure to global real estate depending on risk and return preferences. Investors can choose opportunities in real estate equity or real estate debt. Within each of those asset classes, there are multiple segments, each with its own advantages and disadvantages. The following discussion looks at the range of global real estate investment opportunities, the vehicles designed to capture them, and their relative merits. We also discuss the outlook for real estate following the global financial crisis and economic recession.

A Guide to Global Real Estate Investment Options

By

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Why Global Real Estate?

Investing across regions can offer varied sources of returns, providing additional diversification to a portfolio. Real estate is, ultimately, a local business, with cash flows linked to the physical assets and influenced by local economic conditions. Thus, the timing and nature of real estate returns can be very different depending on prevailing conditions in countries and regions.

Investing globally allows investors to take advantage of region-specific opportunities. They can seek stable value investments in developed markets such as the U.S., the U.K., continental Europe, Canada and Australia. Alternatively, they can target emerging markets with high growth potential such as China and Brazil. Investors need to be aware, though, that going overseas involves risks, including a potential lack of transparency in many markets. While the real estate markets of the U.S. and U.K. are some of the most transparent, with price discovery and market data among the best, corporate governance and reporting standards vary considerably around the world.

Apart from interest rate fluctuations and inflation risk, another potential problem for global investors is the difficulty of identifying appropriate benchmarks for performance. It can also be more challenging to monitor and evaluate investments from a distance. Investing abroad is also likely to incur higher transaction costs, and there is the potential for exposure to foreign exchange risk. Another significant consideration in a globally diversified portfolio is liquidity, especially in less mature and less transparent markets. For many investors, investing in overseas real estate will require specialized expertise.

Below we consider various subclasses of equity and debt investments. Exhibit 1 summarizes the features of each of these asset classes, and Exhibit 2 looks at the pros and cons of each investment form. While not a comprehensive analysis, the following helps frame the issues for this asset class.

Exhibit 1 – Forms of Real Estate Investment

	Investment Form	Description	Investment Vehicle
EQUITY	Direct Real Estate	“Bricks and mortar” investment in physical real estate	Segregated account
	Pooled Investments in Direct Real Estate	Investment in a fund that purchases physical property on behalf of its clients	Ownership in a pooled vehicle, either open-end* or closed-end**
	Listed Real Estate Securities (REITs)	Purchase of shares in publicly traded companies which invest in real estate, such as REITs	Ownership in a pooled vehicle, segregated account, or direct purchase of shares
	REIT Preferred Stock	Preferred stock (or preference shares) are shares that have a priority claim on the REIT’s cash flow	Ownership in a pooled vehicle, segregated account, or direct purchase of securities
DEBT	First Mortgage Debt	Whole loans backed by real properties	Ownership in a pooled vehicle or segregated account
	Commercial Mortgage-Backed Securities (CMBS)	Tranched securities that have as collateral loans secured by commercial property	Ownership in a pooled vehicle, either open-end* or closed-end**
	Mezzanine	Investments that occupy a middle position in the capital stack, as a subordinated debt or preferred equity position	Ownership in a pooled vehicle, either open-end* or closed-end**
	REIT Unsecured Debt	Corporate bonds issued by listed real estate companies	Ownership in a pooled vehicle, segregated account, or direct purchase of securities

*Open-end means that interests can be redeemed periodically based on the market value of assets. **Closed-end means open to subscription for a limited time, limited investment period and life, and limited or no redemption/transfer rights.
Source: Urdang

Exhibit 2 – Pros and Cons of Real Estate Investment Forms

	Investment Form	Pros	Cons
EQUITY	Direct Real Estate	<ul style="list-style-type: none"> ▪ Can target specific markets/ property types ▪ Investment in “hard assets” ▪ Specific cash flows from rental income 	<ul style="list-style-type: none"> ▪ More asset-specific risk ▪ Need for a property/asset manager ▪ Liquidity issues — takes time to sell or buy physical assets ▪ High transaction costs
	Pooled Investments in Direct Real Estate	<ul style="list-style-type: none"> ▪ More diversified portfolio of underlying properties ▪ Potential for increased liquidity 	<ul style="list-style-type: none"> ▪ Product claims to offer daily or monthly liquidity, but underlying assets can take much longer to sell ▪ Transaction costs to buy and sell units are high
	Listed Real Estate Securities (REITs)	<ul style="list-style-type: none"> ▪ Easier to diversify portfolio ▪ Daily liquidity and pricing ▪ Transparency of reporting ▪ Attractive dividend yields 	<ul style="list-style-type: none"> ▪ Moves more in line with short-term movements in broad equity markets
	REIT Preferred Stock	<ul style="list-style-type: none"> ▪ Has a priority claim on cash flow ▪ Higher dividend yields than REIT common stock ▪ Listed on major exchanges and can be traded in small quantities 	<ul style="list-style-type: none"> ▪ Can offer lower total returns than common stock ▪ Liquidity issues
DEBT	First Mortgage Debt	<ul style="list-style-type: none"> ▪ Occupies first position in capital stack ▪ Provides income throughout investment period 	<ul style="list-style-type: none"> ▪ Liquidity issues
	Commercial Mortgage-Backed Securities (CMBS)	<ul style="list-style-type: none"> ▪ Can invest selectively in tranches to manage investment risk profile 	<ul style="list-style-type: none"> ▪ New issuance collapsed in the credit crunch ▪ Diffusing risk to more investors doesn’t make risk disappear
	Mezzanine	<ul style="list-style-type: none"> ▪ Can offer higher returns than first mortgage debt 	<ul style="list-style-type: none"> ▪ Greater risk than first mortgage debt
	REIT Unsecured Debt	<ul style="list-style-type: none"> ▪ Offers greater liquidity than many other forms of real estate debt 	<ul style="list-style-type: none"> ▪ Dependent on a REIT’s ability to repay ▪ Not secured by specific assets ▪ Can be volatile and illiquid

Source: Urdang

Real Estate Equity Investing

Investing in real estate equity covers a broad range, from the direct purchase of a property to buying shares in a real estate investment trust (REIT) or a property unit trust. An investor’s concerns about diversification, liquidity, correlation and transaction costs will affect investment choices. Equity real estate investments can be grouped according to the level of direct or indirect ownership.

Pooled funds generally are able to acquire more properties than an individual investor, and so are able to have a more diversified portfolio of underlying properties.

Direct Property — Investors can purchase physical assets such as an office building, shopping center or warehouse. Done on a relatively large scale by an institutional investor, these investments can be made through a segregated or separate account. Investments can be made in a joint venture with another investor and/or an experienced operating partner, or owned by a single investor. An advantage to this approach is the ability to target specific geographic markets or property types; investors have a great deal of control over their investment strategy.

By buying a physical property, investors have invested in a hard asset and enjoy specific cash flows from rental income, in addition to any gains in value realized at the time of sale. But there is another side to that physicality: direct ownership of property increases the illiquidity of the investment as it takes time to buy or sell a property. In addition, there are high transaction costs associated with property sales. Investors will also have to hire property or asset managers to attend to the day-to-day management of the property — collecting rents, fixing leaky pipes, finding new tenants, etc.

Transparency with regard to valuation is another issue for direct property investors. Indices tracking direct real estate value, such those maintained by the National Council of Real Estate Investment Fiduciaries (NCREIF) in the U.S., and the Investment Property Databank (IPD) in the U.K. and continental Europe, tend to lag the “market.” This is because appraised values are inherently backward-looking; they are based on market evidence which takes time to make its way into the statistics. This “capital appreciation lag” means that valuation and the benchmarking of performance are not easy.

Smaller investors, without as much capital to invest, will find it difficult to achieve adequate diversification within a real estate portfolio of a handful of properties, and the success of these assets can depend greatly on localized factors.

Pooled Funds — A pooled or commingled fund gathers capital from a group of investors and uses it to purchase a portfolio of properties; these investments can include property unit trusts in the United Kingdom, open-end real estate funds in Germany, or private equity real estate funds in the United States. Pooled funds generally are able to acquire more properties than an individual investor, and so are able to have a more diversified portfolio of underlying properties.

Pooled funds can be either open-end or closed-end. A closed-end fund has a fixed term and aims to raise investment money, acquire assets, hold them for a specific period, then sell the assets for a gain. It can be difficult to sell an investment in a closed-end fund before the fund liquidates. While there are a small number of investors that acquire secondary fund interests, valuation is difficult and some funds restrict their investors’ ability to sell their ownership.

An advantage to investing in real estate securities is the speed with which an investor can ramp up a portfolio; it is much quicker to buy stock than it is to buy a building.

Open-end funds do not have a fixed term, and so investors can, in theory at least, buy into the fund or sell out of the fund at their own discretion. Redemptions are generally covered through new investment capital, but during downturns in the property markets — e.g., the early 1990s and late 2000s — when many investors might want to exit a fund at the same time that few investors want to invest, the fund will be forced to sell underlying assets to meet redemption requests. Also in a property downturn, the open-end fund will find it more difficult to sell assets, and long redemption queues can develop. The same issues discussed above surrounding indices and lags in valuation data apply equally to pooled fund structures.

Style of Return — Pooled funds and direct investments can also be segmented by investment style or expected return. Funds can be categorized as core, value-added or opportunistic. A **core** fund will acquire fully leased properties in prime locations. Core is perceived as having lower risk, with expected returns from rental cash flows and moderate appreciation in the 8-12 percent range, assuming a moderate level of leverage. **Value-added** funds occupy the middle ground, with a focus on properties that could benefit from improved leasing or redevelopment and have expected returns of 12-18 percent. **Opportunistic** funds invest in the higher risk, higher reward segment, perhaps investing in ground-up development or distressed assets, and can have expected returns of 18+ percent.¹

Real Estate Securities — Another way for investors to invest in property is through the purchase of real estate securities — equity shares of publicly traded companies that invest in real estate, such as REITs or real estate operating companies (REOCs). Investors can directly purchase real estate securities, or they can invest in a fund or separate account that is professionally managed. REITs, which have an advantageous tax structure by virtue of distributing almost all their taxable income in the form of a dividend, also offer attractive dividend yields, and global REITs have delivered average total returns of just over 9 percent annually over the past 10 years.²

An advantage to investing in real estate securities is the speed with which an investor can ramp up a portfolio; it is much quicker to buy stock than it is to buy a building. Real estate securities can offer daily liquidity and pricing, as well as transparent reporting processes. It is also much easier to invest in a portfolio that is broadly diversified by geographic region and property type compared with buying physical real estate. Listed real estate securities also provide investors with a relatively easy method of investing in global property. The sector lends itself readily to dynamic portfolio management, with the ability to capture outperformance through active overweights and underweights of various property types and/or regions, whose returns are relatively uncorrelated. Although the primary assets of REITs and REOCs are real estate, they are also operating businesses, generally run by experienced management teams with access to capital sources and the know-how to create more value from real estate.

¹ James D. Shilling and Charlie Wurtzbech, "Is Value-Added and Opportunistic Real Estate Investing Beneficial? If So, Why?" *Pension Real Estate Association Research*, April 11, 2010. Higher expected returns also carry a higher risk of loss.

² FTSE EPRA/NAREIT Global Real Estate Index Series (see index definition at back).

An advantage of first mortgage lending is that it occupies the first position in the capital structure, thus making it less risky than equity investing or mezzanine lending.

There are trade-offs, however, that come with being a listed stock investment, one of which is volatility. REITs and other real estate securities are more closely correlated to stock market movements than other real estate investments. The shares often move in line with short-term movements in broad equity markets.

REIT Preferred Stock — REIT preferred stocks (or preference shares) are shares that have a priority claim on the REIT's cash flow, and thus tend to provide higher dividend yields, though lower total returns, than REIT common equity.

REIT preferred stock can be particularly attractive to individual investors because they are mostly listed on major stock exchanges and can be traded in small quantities. Unlike bonds, preferred stocks do not have a fixed maturity date. REIT preferred stock is most commonly issued by U.S.-listed real estate companies; recently we have seen the beginnings of a resurgence in preferred issuance.

Real Estate Debt Investing

Real estate debt investing is typically made through a closed-end pooled fund or separate account structure, due to the fact that debt investments are generally less liquid than equity securities. Investors can have a variety of options along the risk curve and in public and private debt.

First Mortgage Debt — Investors in commercial real estate debt can do so as first mortgage lenders. Although this has largely been the province of insurance companies and banks, there are now opportunities, through commingled funds or separate accounts, to make whole loans backed by one building, or a small number of properties.

An advantage of first mortgage lending is that it occupies the first position in the capital structure, thus making it less risky than equity investing or mezzanine lending. In addition, whole loan investing can provide more stable current yield throughout the investment period, versus some direct property strategies in which income may be more skewed to the "back end" of the investment period after value enhancements to a property (e.g., redevelopment or refurbishment) are completed.

CMBS — Commercial mortgage-backed securities (CMBS) are bonds that have as collateral loans secured by commercial property. Most CMBS transactions are structured as real estate mortgage investment conduits (REMICs), which are intended to hold a pool of mortgages for the exclusive purpose of issuing multiple classes of mortgage-backed securities.

CMBS offerings use credit enhancement and subordination to create tranches with different ratings to meet different investor appetites.

Under the CMBS structure, commercial mortgage loans are pooled and warehoused by a funding source and then securitized and marketed once the pool reaches a critical mass. Investors in CMBS can target investment-grade securities (those with AAA, AA, A and BBB ratings), or non-investment-grade securities (BB, B and unrated classes). CMBS offerings use credit enhancement and subordination to create tranches with different ratings to meet different investor appetites. AAA CMBS is more analogous to bond investing and often falls into investors' fixed income allocation. The non-investment-grade classes, often called the B-piece, are frequently targeted by high-yield debt funds.

New CMBS offerings disappeared in the credit crunch of 2008, but a series of government programs, including the U.S. Term Asset-Backed Securities Loan Facility (TALF), have made efforts to restart CMBS lending programs. In the U.K., supermarket giant Tesco breathed life into the CMBS market in mid-2009 by selling debt backed by its commercial property portfolio.

Mezzanine — Mezzanine investments occupy a middle position in the capital stack, as a subordinated debt or preferred equity position. The investment carries more risk than first mortgage debt, but the returns are generally higher. Mezzanine capital is often used in property development, filling in the gap between construction loans and a developer's equity investment. Mezzanine investment can also be used to recapitalize assets or in place of a joint venture for property acquisitions.

REIT Unsecured Debt — REIT unsecured debt involves corporate bonds issued by real estate investment trusts. These corporate bonds offer greater liquidity than many other forms of real estate debt investing. While some investors hold bonds until maturity, other investors will actively trade these bonds. The liquidity of REIT bonds also gives rise to higher volatility, as they can fluctuate in response to economic conditions and broader market movements.

Unsecured debt is dependent on the company's ability to repay the bond and is not secured by specific assets, unlike a mortgage. However, REITs do have tangible assets on their balance sheets, which makes their corporate bonds attractive to investors.

Returns and Fees

In addition to different risk characteristics, investors need to consider both fee structures (including timing of fees charged) and differing return levels. Exhibit 3 shows the general range of fees that investors would expect to pay on various fund structures, while the following chart shows returns from various real estate asset classes from 1997 to 2008 (it is important to keep in mind the variability within the average returns).

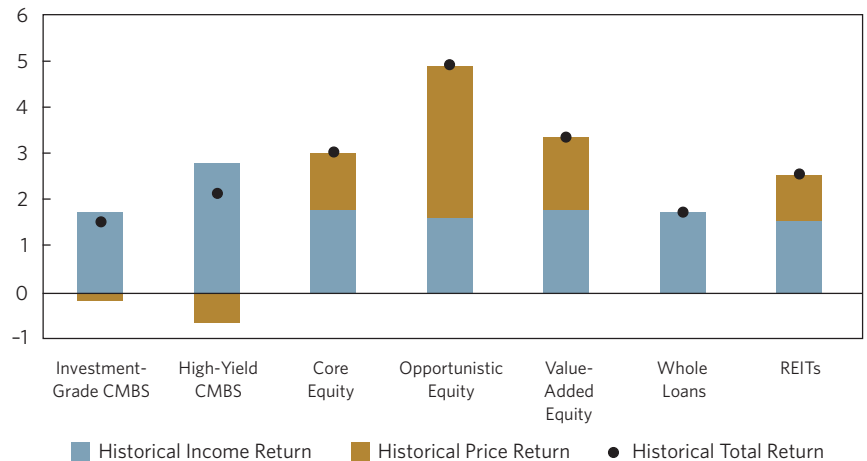
Exhibit 3 - Typical Fee Structures

Investment Form	Asset Types	Typical Fees/Structure
Real Estate Private Equity - closed end pooled vehicles	<ul style="list-style-type: none"> • Direct Property • Real Estate Debt • Real Estate Funds (“fund of funds”) 	<ul style="list-style-type: none"> • 3 year investment period; 7 year total fund life • Asset Management Fee: 100-150 bps on committed/ deployed equity (preferential terms available for seed investors/larger commitments) • Manager typically receives a promote, or carried interest — i.e. and increased share of residual cashflows above an IRR/preferred return hurdle when the fund is liquidated • Asset acquisition or disposition fees may be included (50-200 bps) • All-in annual cost*: 250-350 bps
Real Estate Private Equity - Separate Accounts	<ul style="list-style-type: none"> • Direct Property 	<ul style="list-style-type: none"> • Asset Management fee charged as a percentage of invested/committed capital • Acquisition or disposition fees may be included (50-200 bps) • Incentive fee typically based on returns from sale of portfolio assets; tested at portfolio level • All-in annual cost*: 100-200 bps
Pooled Investments in Direct Real Estate – typically open ended	<ul style="list-style-type: none"> • Direct Property • Some funds hold real estate securities as a liquidity buffer 	<ul style="list-style-type: none"> • 100-200 bps on fund net asset value • Exit and entrance fee implicit in wide bid/ask spread for units.
Real Estate Securities Funds/ Separate Accounts	<ul style="list-style-type: none"> • Real Estate Securities 	<ul style="list-style-type: none"> • 100-200 bps on net asset value; lower for larger accounts • Some separate accounts offer performance fee structures with a significantly lower base fee and an incentive fee based on benchmark outperformance

* The all-in annual cost represents the expected difference in annual return between an equity internal rate of return (IRR) calculation on a gross basis, versus an IRR calculation net of all fees and incentive payments/promotes.
Source: Urdang

Historical Performance of Real Estate Asset Classes, 1997-2008

Average Quarterly Return (%)



Note: CMBS and REIT data are as of 31 December 2008, whole loans data are as of 30 September 2008, and equity data are as of 30 June 2008. Please see Index Disclosures at back for the proxies used for each asset class.

Source: Based on data from PPR, Lehman Brothers, NCREIF, Giliberto-Levy, and National Association of Real Estate Investment Trusts (NAREIT).

We expect the decoupling of global markets will have a significant impact on returns. Asian markets, excluding Japan, and emerging markets will be near-term winners, but volatile.

Global Real Estate Outlook

The global financial crisis began in the U.S. subprime real estate market and affected property markets across the world. We expect that real estate fundamentals will decline well into 2010 in many global markets. Commercial real estate lending was too aggressive during the property boom, and now write-downs of bad loans will continue; some borrowers will be unable to refinance. The economic downturn means that cash flows from rental income will decline or at best stay flat, as occupancy levels and rental rates decline, though we expect demand will pick up again during the second half of 2010.

Despite these problems, we believe there is cause for optimism. We expect real estate values to stabilize this year. New real estate development has ground to a halt, with the pipeline of new assets in major markets at a very low level. The lack of supply of new space will ultimately result in falling vacancy rates and increasing rents. This will lead development to restart; we are already seeing signs of this in central London, where the leasing environment is improving and rents are rising strongly.

We are moving into a real estate investing environment with lower debt levels and lower expected returns. There will be more focus on rental income security, and less on capital gains from property price appreciation.

We expect the decoupling of global markets will have a significant impact on returns. Asian markets, excluding Japan, and emerging markets will be near-term winners, but volatile. Low growth in the U.S., U.K. and continental Europe will likely shift investors' focus to income in those markets.

As the universe of investment opportunities expands globally, so too does the stock of high-quality real estate assets investors can consider for deepening their sources of diversification.

Private real estate investors have had trouble raising new equity, while listed REITs are shaping up to be in the best position for the next few years. Listed REITs have strengthened balance sheets by raising new equity, and with their experienced management teams, will be able to take advantage of distress in the real estate markets and will have the financial strength to develop new properties as demand for space returns.

Listed real estate securities are generally a leading indicator of the recovery of the real estate markets; thus we have already seen a significant rally in most global listed markets, in line with the broad equity market recovery. However, we still believe that great value and growth opportunities abound for an active manager.

In the direct property market, the emergence of distress has been slow, with banks continuing to subscribe to the “extend and pretend” strategy with regard to their commercial real estate loan books. However, those with access to equity and less reliance on debt funding are starting to see more distressed opportunities at great prices coming from those in immediate distress or in need of short-term liquidity.

As banks in the U.K., continental Europe and the U.S. start to address their loan portfolios more proactively, we think the opportunity for debt investing will expand significantly. Investors should be able to bridge the gap between demand for first mortgage (or mezzanine) refinancing and the reduced appetite of commercial banks for real estate exposure. We expect that the CMBS market will return, albeit on a smaller, simpler, more conservative scale. Further up the risk spectrum, there will be opportunities to invest in distressed situations through the purchase of deeply discounted existing performing loans, or participation in nonperforming “loan-to-own” situations. However, the key to success with all of these strategies is a thorough understanding of the underlying real estate collateral; after all, an investor has to be ready to own the real estate should a loan default.

With such a wide range of choices, investors should carefully consider their return objectives as well their risk appetite and volatility tolerance. As the universe of investment opportunities expands globally, so too does the stock of high-quality real estate assets investors can consider for deepening their sources of diversification.



E. Todd Briddell, CFA

Todd is the President and Chief Investment Officer of Urdang Capital Management, Inc., the real estate investment advisory subsidiary of BNY Mellon Corporation. He is responsible for developing and leading Urdang's global investment activities in listed property securities, commercial mortgage debt and private equity real estate. Mr. Briddell joined

Urdang's private equity acquisitions group in 1993, founded the listed property securities group in 1995 and led the design and development of its commercial real estate debt team in 2009. Mr. Briddell has more than 19 years of real estate investment experience.

Prior to joining Urdang, Mr. Briddell worked for a pension fund advisor and was focused on distressed debt and property acquisitions, loan workouts and the takeover and restructuring of a third-party opportunity fund. Mr. Briddell has a B.S. in economics from the University of Pennsylvania. He is a member of NAREIT and the CFA Institute.

Index Definitions and Disclosures

The FTSE EPRA/NAREIT Developed Markets Indices include a range of regional and country indices, Dividend+ indices, Global Sectors, Investment Focus, and a REITs and Non-REITs series.

Investment-Grade CMBS – The Barclays Capital Investment Grade CMBS Index is an index designed to mirror commercial mortgage back securities of investment grade quality (Baa3/BBB-/BBB- or above) using Moody's, S&P, and Fitch respectively, with maturity of at least one year.

High-Yield CMBS – The Barclays Capital High Yield CMBS Index is an index designed to mirror commercial mortgage back securities rated Ba1 or lower using the middle rating of Moody's, Fitch, and S&P with maturity of at least one year.

Core Equity – The NCREIF/Townsend Fund Index - Core Equity is an index designed to mirror private equity real estate funds pursuing core equity strategies using both open-ended and closed-ended structures.

Opportunistic Equity – The NCREIF/Townsend Fund Index - Opportunistic Equity is an index designed to mirror private equity real estate funds pursuing opportunistic equity strategies using both open-ended and closed-ended structures.

Value-Added Equity – The NCREIF/Townsend Fund Index - Value-Added Equity is an index designed to mirror private equity real estate funds pursuing value-added equity strategies using both open-ended and closed-ended structures.

Whole Loans – The Gilberto-Levy Commercial Mortgage Performance Index is a benchmark to measure the performance of commercial mortgage portfolios. Established in 1993, the index measures the quarterly total return produced by a model portfolio of institutional-grade commercial mortgage whole loans.

REITs – The NAREIT Equity Index is an unmanaged index of all tax-qualified REITs listed on the NYSE, AMEX and NASDAQ which have 75% or more of their gross invested book assets invested directly or indirectly in the equity ownership of real estate. Investments cannot be made directly in the NAREIT Equity Index. Total return calculation for the NAREIT Equity Index include reinvestment of distributions.

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